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Ethics 2000 and Insurance
Defense Conflicts of Interest in Kentucky

BY CRAIG PAULUS*

INTRODUCTION

With the approach of the year 2000, the American Bar Association has undertaken a project to review and revise the Model Rules of Professional Responsibility. The ABA’s Ethics 2000 Commission is currently re-examining old rules and considering new ones. This Comment examines how these revisions may or may not affect the ethics of insurance defense in Kentucky.

Conflicting loyalties and interests can put an insurance defense attorney in a position of choosing between the interests of the insured, her true client, and the insurance company, her true employer. Confidentiality and candor can become muddled in questions of insurance defense. The seemingly simple tripartite relationship of lawyer, insured, and insurer can rapidly devolve into a complex web of conflicts. Kentucky’s Rules of Professional Responsibility, based on the current ABA Model Rules, have their own way of solving the insurance defense dilemma. If the Ethics 2000 proposals were adopted, however, Kentucky’s current system would be affected.

This Comment presents an analysis of the current law of Kentucky and how the Ethics 2000 proposals would change the current system. To conclude, a brief outline of the safeguards in Kentucky’s professional rules with particular emphasis on how the insurance defense attorney can use these to her advantage will be offered.

I. KENTUCKY LAW AND THE ETHICS 2000 PROPOSALS

Kentucky law is straightforward in its treatment of the ethics of insurance defense. The one fundamental principle that guides conduct in

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this area is the rule that the insured is the client.\(^2\) This is the most appropriate theoretical system under the Model Rules and has two fundamental advantages over allowing the insurer to be considered the client. First, it gives the insured more effective representation by allowing him to be candid with his attorney. Second, it allows the lawyer to conduct the representation without the ever-present danger of a mandatory withdrawal. The immediate corollary of this rule, which is perhaps even more important than the rule itself, is that the insurer is not the client. It is well known that the "defense counsel's duty to the insured arises from the attorney-client relationship and is governed by the Rules of Professional Conduct."\(^3\) The insurance company is merely a third party payor as described in Rule 1.8(f).\(^4\)

Although this principle must never be ignored, the insurer is not without a voice in the relationship. Rule 1.2 divides the decision-making authority of the client and the attorney, generally placing the objectives of representation in the hands of the client and the means of representation in the discretion of the lawyer.\(^5\) While there is apparently no place for a third party to make decisions under this scheme, the Proposed Final Draft of the Restatement (Third) of the Law Governing Lawyers suggests that the third party payor may have some part to play in decision-making.\(^6\) The Ethics 2000 Commission has looked to the Restatement for guidance as to revisions in this area and others. Regardless of the outcome of the Restatement, even where confidentiality is protected, the quality of representation cannot be sacrificed.\(^7\)

Kentucky’s Rule 1.8(f)(1) states that a lawyer shall not accept compensation from a third party unless such compensation is “in accordance with an agreement between the client and the third party,"\(^8\) such as an insurance contract.\(^9\) The comment to Rule 1.7 of the ABA Model Rules

\(^3\) Id.
\(^4\) See KY. SUP. CT. R. 3.130-1.8(f). This does not mean, however, that the lawyer owes no duty to the insurer. The Rules impose duties on the lawyer when dealing with any third party. Where a lawyer works closely with an insurance company but must maintain the confidentiality of the insured, the most important rule to remember is honesty. See id. 3.130-4.1.
\(^5\) See id. 3.130-1.2.
\(^7\) See KY. SUP. CT. R. 3.130-1.1.
\(^8\) Id. 3.130-1.8(f)(1).
\(^9\) See id. The client may consent to third party payment as well. Additionally, there are other requirements, including no interference with the lawyer’s
of Professional Conduct (as well as Kentucky's Rule 1.7) specifically discusses a conflict of interest between a third party payor and the client.\textsuperscript{10} Using insurance defense as an example, this comment states that the insurance company is required to provide special counsel for the insured if there is a conflict of interest.\textsuperscript{11} This is the law of many jurisdictions and can lead to conflicting loyalties.\textsuperscript{12} However, in Kentucky, this should never be a problem. Kentucky does not permit insurance companies to appoint in-house counsel or staff attorneys to represent insured customers.\textsuperscript{13} This is due to the inherent conflicts of interest as well as the rules against corporate practice of law and unauthorized practice of law.\textsuperscript{14} Where the insurer is also a client or acts as the attorney, the insured risks losing the benefits of insurance by being candid with his attorney. In such a case, the "captive" attorney cannot avoid a conflict. Instead, the attorney can merely detect a conflict and withdraw from the case. Obviously, if an attorney is allowed to represent both the insurance company and the insured as clients,
conflict situations can ambush the attorney without warning. The waylaid
attorney must then withdraw under Rule 1.16, causing undue delay,
inconvenience, and expense.15

Suppose, for example, that an insurance company sends its staff
attorney to represent the victim of an auto accident. In the initial interview,
the staff attorney receives information from the insured that would provide
a coverage defense for the insurer. The attorney is suddenly in a conflict
situation. Further, the insured is at a disadvantage under this arrangement
because the attorney’s withdrawal signals the existence of a defense to the
insurance company. Failure to withdraw when in a conflict can lead to
liability, and in some circumstances, a waiver is ineffective. In Conrad
Chevrolet, Inc. v. Rood,16 a lawyer represented both the buyer and the seller
in the sale of an automobile franchise.17 The seller’s action for fraud and
negligence was dismissed on the basis of an alleged release of the attorney
signed by all parties at the closing. The release “purported to waive any
conflicts of interest which might exist between [seller] Conrad and [buyer]
Blackhorse so that [the attorney] could represent both.”18 The Kentucky
Supreme Court reversed a summary judgment for the attorney, holding that
“this ‘waiver’ signed by Conrad cannot, as a matter of law, preclude a trial
upon the issues.”19 The Court also stated that when an attorney possesses
secret information of one client vital to the other, adequate consultation and
disclosure is not possible. Consequently, a waiver is defective.20 The fact
that a waiver is not a cure-all to a conflict is a stark reminder of the
seriousness of the conflict rules.

The Ethics 2000 Commission has discussed a possible revision of Rule
1.8(f). This rule currently reads:

A lawyer shall not accept compensation for representing a client from one
other than the client unless:

(1) the client consents after consultation;
(2) there is no interference with the lawyer’s independence of
professional judgment or with the client-lawyer relationship; and

15 See KY. SUP. CT. R. 3.130-1.16 ("[A] lawyer . . . shall withdraw from the
representation of a client if: (1) The representation will result in a violation of the
Rules of Professional Conduct . . . ").
16 Conrad Chevrolet, Inc. v. Rood, 862 S.W.2d 312 (Ky. 1993).
17 See id. at 313.
18 Id.
19 Id.
20 See id. at 314.
As noted above, the commission has considered incorporating the notion that the insurer should have more power to direct litigation as drawn from section 215 of the Restatement (Third) of the Law Governing Lawyers. Section 215 states: "A lawyer's professional conduct on behalf of a client may be directed by someone other than the client when: (a) the direction is reasonable in scope and character, such as by reflecting obligations borne by the person directing the lawyer; and (b) the client consents to the direction . . . ." The commentary to this section provides the example of an insurance contract that gives the insurer the authority to decide issues concerning litigation expenses. Where a tactical decision, such as taking additional costly depositions, will not cause the lawyer to fall below the required standard of care and is merely a financial decision, the lawyer may comply with the demands of the insurer. Since the insurer is bearing the costs and possibly the ultimate liability in the litigation, the insurer has standing to assert a claim for professional negligence in the conduct of that litigation. The comment and illustration to this Restatement section thus address the conflict of interest problem in this situation though the black letter law of section 215 does not. Where there is a conflict of interest, the attorney must act in the client's interest even under section 215. This generally means that protecting confidential communications is of foremost importance and that choosing whether to spend more time and money conducting discovery is a tangential matter.

Kentucky may not agree with the Restatement. Formal Ethics Opinion E-331 makes it clear that budget restrictions imposed by the insurance carrier are touchy matters and can lead to ethical conflicts. In fact, when the carrier's demands begin to affect the attorney's independent judgment, withdrawal may be justified or even required. It must be remembered that though the insurance contract is a "'hard-boiled commercial'" relationship,
the attorney-client relationship is not. The ethics of the situation are fact-sensitive. For instance, perhaps the insurance carrier should receive more deference when the claim is within the policy limits and the insured has little personal risk.

There is the possibility of creating a specific rule within the Model Rules to clarify the duties of an insurance defense lawyer when conflicts occur between insurer and insured. The latter proposal is suggested in the writings of Richard Zitrin. Zitrin states:

The rule should make clear that conflicts that occur during the course of the representation of an insured under a policy of insurance must result in the lawyer in question protecting the rights of the insured, even at the expense of the insurer, and must include maintaining confidences of the insured even where revelation of those confidences would ordinarily be provided the insurer in a non-conflict situation.

This proposal comports with the approach already taken in Kentucky ethics opinions. Despite the fact that such a rule has not been released, the proposal may provide useful guidance and clarification. In short, the concept of a specific insurance defense rule is not without merit.

Another substantive proposal would expand the text of Rule 1.7 and clarify when it is permissible to seek a client's consent to a conflict of interest. This expansion may be of more import to Kentucky's rules governing insurance defense as well as dual representation cases than a new rule. Although the lawyer does not "represent" the insurer, an

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28 Id. (quoting Moritz v. Medical Protective Co., 428 F. Supp. 865, 872 (W.D. Wis. 1977)).
29 If the proper course of action is not clear and the situation cannot be resolved amicably, seeking an advisory opinion is a good idea. See infra notes 48-51 and accompanying text. Of course, the jury may surprise the insured with a judgment greater than expected.
31 Id.
34 See Conrad Chevrolet, Inc. v. Rood, 862 S.W.2d 312 (Ky. 1993). This case sets one boundary in this area: an attorney cannot represent two parties when
ongoing relationship can create a conflict. In particular, an attorney who receives a substantial amount of work from a particular insurer may find that her financial self-interest clouds, or appears to cloud, her judgment.\textsuperscript{35} Guidance as to when it is inappropriate to ask for a client's consent would be helpful in a number of situations.

Other potential modifications to Rule 1.7 include clarifications of the exceptions to the rule. These would be largely a matter of form over substance. Currently, the rule reads, "A lawyer shall not represent a client if the representation of the client may be materially limited . . . unless the lawyer reasonably believes the representation will not be adversely affected."\textsuperscript{36} One suggested revision would change this proviso language to read, "[unless] the lawyer reasonably believes the lawyer will be able to provide competent and diligent representation to each affected client."\textsuperscript{37} The debate over this rule has included the suggestion that the two exceptions, this one for "competent and diligent representation"\textsuperscript{38} and the client-consent exception, should be collapsed as in section 201 of the \textit{Restatement (Third) of the Law Governing Lawyers}.\textsuperscript{39} Again, this proposed change would not be of great substantive significance.

possession of one client's confidential information is vital to the other client. The case also indirectly permits professional negligence liability to be premised on the failure of an attorney to withdraw. \textit{See id. at} 313-14; \textit{supra} notes 15-20 and accompanying text.

\textsuperscript{35} \textit{See} Fla. State Bar Ass'n Comm. on Professional Ethics, Op. 98-2 (1998), \textit{available in} 1998 WL 796691; Ohio Bd. of Comm'rs on Grievance and Discipline, Op. 97-7 (1997), \textit{available in} 1997 WL 782951. These opinions discuss the propriety of flat rate compensation for the insurance defense attorney, concluding that professional independence is the touchstone of ethical responsibility.

\textsuperscript{36} \textit{MODEL RULES OF PROFESSIONAL CONDUCT} Rule 1.7 (1998).


\textsuperscript{38} \textit{Id.}

\textsuperscript{39} \textit{See} \textit{RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS} § 201 (Proposed Final Draft No. 1, 1996). The "competent and diligent representation" revision was suggested and passed unanimously by the Commission in September 1998. Center for Professional Responsibility, \textit{Ethics 2000 Meeting Minutes, supra} note 37. However, an approach similar to that used in section 201 of the Restatement was then discussed and rejected at the December 1998 meeting. \textit{See} Center for Professional Responsibility, \textit{American Bar Association Center for Professional Responsibility Commission on Evaluation of the Rules of Professional Conduct (Ethics 2000)-Minutes} (visited May 18, 1999) <http://www.abanet.org/cpr/e2k/121198mtg.html>.
II. PRACTICAL CONSIDERATIONS AND TECHNIQUES

In application, the principle that the insured is the client means protecting the confidential information of that client from the person who is paying the bill. Loyalty and confidentiality demand that the lawyer who is privy to information that may give a defense to the insurer keep such information confidential. Nevertheless, there are common scenarios—some seemingly innocent—that must be guarded against by the vigilant lawyer.

Consider for example, the seemingly innocent request by the insurer to have a representative present at a deposition. In fact, it is generally improper for a Kentucky attorney to allow an insurance company to have a representative present at the deposition of the insured. Even when the insurance company demands to have a representative present, the attorney must resist if it puts the insured at risk. Further, even though waiver of the attorney-client privilege and work product protection should generally be considered and avoided, when the insurance carrier and the insured are cooperating in a “common interest arrangement,” the privileges are waived between the cooperating parties.

Insurance defense conflicts come in all shapes and sizes. Consider these simple examples: (1) a lawsuit is brought claiming two causes of action, one covered by the insurance policy and the other not; (2) the amount of the claim exceeds the policy limitations or a considerable deductible gives the insured and the carrier different incentives to settle; (3) there are possible coverage defenses, all of which would negate the insurance company’s duty to pay; (4) a claim is brought against the

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41 See Ky. Bar Ass’n, Formal Op. E-340 (1990). This is not a per se rule. There are instances in which the insurer should have a representative present. However, this opinion strongly hints that giving in to the insurer’s demands when it is prejudicial to the client can lead to malpractice liability. See id.
42 See id.
44 See Or. Bar Ass’n Bd. of Governors, Formal Op. 1991-121 (1991). When the covered claim is subject to a motion to dismiss and the other is not, the insured has a strong incentive not to have the former dismissed. If it were dismissed, he would lose the benefit of a carrier-paid defense. According to this opinion, the attorney cannot ethically move to dismiss the claim against the wishes of the insured. Ironically, Oregon considers both the insured and the insurer clients. See id.
insurance company itself; the insured is or may be committing fraud. In these situations, the professionally responsible course of action may not always be clear, but there are some techniques that can protect the attorney from discipline and liability.

The first is the advisory opinion. Under Kentucky Supreme Court Rule 3.530, an attorney in doubt as to the ethical propriety of a course of action may request advice from the Ethics Committee. In emergencies, the request can be made over the telephone. A prompt telephonic answer is given, followed by an informal letter. This system has several advantages. First, it provides practical, helpful guidance. Further, all information given to the Ethics Committee member furnishing the opinion is kept confidential.

There is, however, the possibility that the ethical guidance will be wrong, and the lawyer will violate the Rules of Professional Conduct by following it. In such a case, following the guidance of the advisory opinion protects the attorney from professional discipline regardless of the soundness of the advice. Unfortunately, it does not protect against liability arising from professional negligence or a breach of fiduciary duty. Nonetheless, the advisory opinion is an excellent tool for avoiding ethical violations.

Ethical problems may also be avoided by limiting the scope of representation and limiting liability prospectively. The latter method is straightforward but disfavored by the Kentucky Rules of Professional

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46 See Ky Bar Ass'n, Formal Op. E-378 (1995). This scenario is one where the insured is sued and, in turn, the carrier has a claim filed against it under the Unfair Claims Settlement Practices Act (“UCSPA”). The insurer must not insist on the dismissal of the UCSPA claims as a condition of settlement. The Kentucky Bar Association believes that “defense counsel should be free to abide by the insured’s decisions concerning the objectives of the litigation and settlement.” Id.

47 See KY. SUP. CT. R. 3.130-1.2(d) (“A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent . . . .”). However, the lawyer is prevented from disclosing the fraud to the insurance carrier by Rule 1.6. See id. 3.130-1.2(d) cmt. In a now familiar turn of events, the attorney may be obliged to withdraw under Rule 1.16. See id. 3.130-1.16. Crime and fraud also give rise to exceptions to the evidentiary attorney-client privilege. See KY. R. EVID. 503(d)(1).

48 See KY. SUP. CT. R. 3.530.

49 See id. 3.530(1)(b).

50 See id. 3.530(7). However, no attorney-client relationship is formed, and the committee member furnishing the opinion is insulated from liability for advice given in good faith.

51 See id. 3.530(3).
Conduct.\textsuperscript{52} There are two key limitations on the lawyer's ability to disclaim liability. The client must be independently represented, and the agreement must be otherwise permitted by law.\textsuperscript{53} Such an arrangement can easily look like overreaching by the attorney, and a conflict of interest is inherent in such an agreement.

As for limiting the scope of representation, Rule 1.2(c) states that "[a] lawyer may limit the objectives of the representation if the client consents after consultation."\textsuperscript{54} For example, when representing an insured and the carrier in wholly unrelated matters, a potential for a conflict of interest exists. Prudence would dictate that the carrier and the attorney come to an understanding about the scope of their relationship. Though the rule does not demand a writing, a memorandum of the agreement or understanding is a good idea. Some sources suggest that if a client insists that the lawyer limit the scope of the representation of another client, the lawyer need not comply.\textsuperscript{55} It seems wholly appropriate that a third party cannot dictate the terms of another client's relationship with his attorney. The aggrieved client may simply find another attorney. However, the temptation to misrepresent the scope of an attorney-client relationship must be resisted. Deception of this kind is certain to violate the Rules of Professional Conduct.\textsuperscript{56} Further, the scope of the representation cannot be limited such that it would violate the Rules themselves. In other words, the lawyer cannot limit the representation to the point that counsel would be inadequate or improper.\textsuperscript{57}

\section*{CONCLUSION}

The protection of clients and the guidance of lawyers should be the goal of any set of ethics rules. Though the ethical framework for the insurance defense counsel in Kentucky is quite comprehensive, the Ethics 2000 proposals may have something to add, especially in addressing client consent to a conflict.\textsuperscript{58} Kentucky should examine the results of the Ethics

\textsuperscript{52} See id. 3.130-1.8(h).

\textsuperscript{53} See id.

\textsuperscript{54} Id. 3.130-1.2(c).

\textsuperscript{55} See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 201 cmt. g (Proposed Final Draft No. 1, 1996).

\textsuperscript{56} See KY. SUP. CT. R. 3.130-1.1, 1.4; see also RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 201 cmt. g.

\textsuperscript{57} See KY. SUP. CT. R. 3.130-1.1 to 1.4.

\textsuperscript{58} See supra notes 33-35 and accompanying text.
2000 Project when the proposals are finalized and consider updating the state's rules to further clarify the proper roles and protect the insured. In the meantime, the prudent Kentucky lawyer should follow the guiding principal of insurance defense: the insured is the client.